

Market Commentary

Climbing a Wall of Worry

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Given all of the dismal news and grim prognostications, the performance of the stock market during the first quarter of 2006 has been a bit of surprise to many people. Despite the wall of worry, the market turned in a very good performance across the board during the past three months. Why has this happened and can it continue?

In attempting to explain the reasons why long term interest rates have not moved up as the Federal Reserve has raised short term rates, new Fed Chairman Bernanke and others have suggested that one possibility is that the world is awash in capital which needs to be invested, and those funds are ending up in longer maturity U.S. Treasury debt and other securities including equities. The pool of investment capital comes partly from other countries with which the United States has large trade deficits. It also is produced by a continued inflow of retirement funds into 401k and other retirement vehicles. We think this a logical explanation not only for the continued low level of longer term interest rates, but also for the strength of the stock market.

While some have fretted about the rising trade deficits (which are caused in part by the seemingly insatiable appetite of U.S. car owners for gasoline) and the potential impact on the value of the dollar, all of this money needs to be put to work. The reality is that there are relatively few places for foreign investors to place it. U.S. investment markets are the largest, most liquid and transparent in the world, and U.S. Treasury securities remain the safest and most liquid investments. We may crave products produced by other countries, but they have an equal need for our investment markets as a place to store the money they get when Americans buy their products and fill their cars with their petroleum.

Despite the Fed's more than two year campaign to raise interest rates, long term rates, which to a great extent finance housing and capital expenditures by business, remain relatively low. They are high enough to attract foreign investment and low enough not to pull large amounts of money out of the stock market. They also remain sufficiently low to continue to fuel the growth (albeit more moderate) of real estate prices.

The best market environment is not one in which everyone is optimistic, but rather one in which some are sitting on the sidelines and others profess nervousness. In short, stocks continue to offer good investment opportunities.

Equally important, while there are some exceptions, valuations of stocks remain reasonable. Tax rates on dividends and capital gains remain relatively low and overall price earnings multiples are within historic ranges. Earnings reports so far this year have produced more positive than negative surprises. The excessive optimism of the late 1990's has largely been tempered by the realities of the 2000 through 2002 market slump, and thus investors have a healthy degree of caution. The best market environment is not one in which everyone is optimistic, but rather one in which some are sitting on the sidelines and others profess nervousness. In short, stocks continue to offer good investment opportunities.

There are a number of things to cause worry including continued increases in interest rates, oil spiking up to \$100 per barrel due to a major supply disruption, trade deficits really spinning out of control and U.S. budget deficits, to name a few of the popular concerns. Each of these things has caused the market to tumble on occasion, and there are signs of increasing market volatility. Nevertheless the declines have usually been followed by healthy rebounds.

This isn't to say that we are in a 1990's era of double digit returns, because we think that's unrealistic. However returns which exceed other liquid investments are not an unreasonable goal. In short, it is easy to lose the positives in an ocean of negatives.

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